



A REPORT
TO THE
MONTANA
LEGISLATURE

PERFORMANCE AUDIT

Land Banking Program

*The Department of Natural Resources
and Conservation*

SEPTEMBER 2010

LEGISLATIVE AUDIT
DIVISION

10P-08

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We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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September 2010

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of the Land Banking Program. This report includes five recommendations, including improving the appraisal process and management controls for the program. A written response from the Department of Natural Resources and Conservation is included at the end of the report.

We wish to express our appreciation to the Director and staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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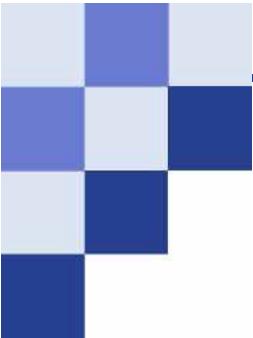
APPOINTED AND ADMINISTRATIVE OFFICIALS

Department of Natural Resources and Conservation

Mary Sexton, Director
Tom Schultz, Administrator, Trust Land Management Division
Jeanne Holmgren, Chief, Real Estate Management Bureau
John Grimm, Supervisor, Real Estate Section

State Board of Land Commissioners

Brian Schweitzer, Governor
Steve Bullock, Attorney General
Denise Juneau, Superintendent of Public Instruction
Monica Lindeen, State Auditor
Linda McCulloch, Secretary of State



MONTANA LEGISLATIVE AUDIT DIVISION

PERFORMANCE

Land Banking Program

The Department of Natural Resources and Conservation

SEPTEMBER 2010

10P-08

REPORT SUMMARY

The Department of Natural Resources and Conservation should improve current Land Banking practices to better balance the short-and long-term impacts to trust beneficiaries.

Context

Established in 2003, the Land Banking Program provides the department with the ability to utilize proceeds from the sale of state trust land to purchase replacement trust land or improvements, which are likely to generate as much or more revenue than the land sold. The program completed its first sale in 2006. To date, the program has sold nearly 42,968 acres of trust land and purchased about 31,588 acres of replacement land. After the completion of audit work, the program acquired an additional 14,581 acres of timber land in July 2010. According to the program, while the land sold generated \$60,644 annually, land acquired is estimated to generate \$303,746 annually, providing greater revenue for trust beneficiaries. Since 2006, the program has acquired ten properties. There have been 504 parcels nominated for sale by the program. Parcels nominated for sale fall into five categories, namely sold, withdrawn, declined, active, and inactive. Of those 504 parcels nominated for sale, 179 parcels have been sold across the state. Other parcels nominated for sale

are either under active consideration of the department or have been removed from consideration for sale by the department or lessee who nominated the parcel for sale. Inactive sale nominations represent nominations which do not fit any of the other categories and are not actively being considered by the department.

Audit work examined how the program values land sold and acquired, determines parcel suitability, and projects rates of financial return on acquisitions. To do this, we reviewed program land sales and acquisitions through February 2010. The majority of parcels sold by the program are isolated without legal public access. Administrative rules for the program require that two appraised values be developed for sales, namely a value with and without access; however, audit work indicated that only 50 percent of appraisals provide both values as required by administrative rules. Audit work also identified inconsistencies in the selection of comparable properties by appraisers to support valuations. While the practice of appraising isolated land with legal access increases the price of a sale, it can also inhibit the program and provide a disincentive for lessees to participate. Audit work demonstrated valuing isolated parcels with legal access increased the appraised price between 20 to 70 percent. Subsequently, participants withdraw from the program. We found approximately 40 percent of participants withdraw from the program due to the appraised price. When a parcel is withdrawn from the program, it generally reverts to the leasing agreement between the department and the lessee, generating limited returns for beneficiaries. When this happens, it can take over 100 years for the department to generate revenue which matches the market value of the land. Presently, the department does not balance the short- and long-term impacts to beneficiaries of trying to sell an isolated parcel with legal access.

Table 1
Land Sold and Acquired by Land Classification Through February 2010

Land Classification	Acres Sold	Acres Acquired
Agricultural	58.4	6,106.1
Grazing	42,907.5	20,806.6
Timber	0	4,257.8
Other	2	417.2
Totals	42,967.9	31,587.7

Source: Compiled by the Legislative Audit Division from department program records.

Audit work also noted a lack of active management for the program. We identified a general deference within the department to allow area land staff to individually guide program activities rather than adhering to centralized set of practices. We noted inconsistencies in program documentation and the process used to identify suitable candidates for the program. This limited our ability to determine fully if the program is working as the legislature intended. The level of commitment to the program by area land offices varied, with some area land staff more actively engaged than others. Consequently, not all parcels which could be suitable candidates for the program are actively being considered. The department also does not have a formal process to evaluate the ongoing performance of acquisitions to determine if they are performing as expected.

Results

Audit recommendations address the need for the department to improve the appraisal process and strengthen management controls for the program. Recommendations include:

- Complying with administrative rules regarding the inclusion of two values in sales appraisals.

- Defining what constitutes a comparable for program sales.
- Considering the short- and long-term financial impacts to trust beneficiaries when trying to sell an isolated parcel with legal access.
- Determining when and where documentation should be retained to support program decisions.
- Establishing adaptable statewide guidelines for identifying parcels for sales and acquisitions and taking steps to ensure identified parcels fall within these guidelines.
- Establishing a formal process to periodically evaluate the performance of program acquisitions.

Recommendation Concurrence	
Concur	4
Partially Concur	1
Do Not Concur	

Source: Agency audit response included in final report.

Chapter I – Introduction

Introduction

The mission of the Trust Land Management Division (division) within the Department of Natural Resources and Conservation (department) is to manage the State of Montana's trust land resources to produce revenue for the trust beneficiaries while considering environmental factors and protecting the future income-generating capacity of the land. The department has a constitutional responsibility to manage about 11 million acres (surface, mineral, and submerged acres) of state school trust land, including forest, agricultural, grazing, and commercial properties that earn revenue to help fund public schools and universities in the state. In an effort to manage these trust lands more effectively, improve their value, increase their potential for earning income, and reduce financial risks to the beneficiaries, the department utilizes land transactions such as sales, purchases, or exchanges.

The Land Banking Program (program) is one way in which the department manages state trust lands. Established by the Legislature in 2003, the program provides the department with the ability to utilize proceeds from the sale of state trust land to purchase replacement trust land or improvements, which are likely to generate as much or more revenue than the land sold. The Legislative Audit Committee identified a performance audit of this program as a priority.

Audit Objectives

We developed three objectives to evaluate how the program:

- ◆ Values land sold and acquired by the program.
- ◆ Determines if a land parcel is a suitable candidate for the program.
- ◆ Projects rates of financial return on potential acquisitions.

Audit Scope and Methodologies

While the State Board of Land Commissioners (land board) ultimately makes decisions regarding the sale and purchase of trust land, our examination focused on program activities performed by the department prior to the involvement of the land board. The appraisal process was examined to determine if it complies with criteria in statute and rule and provides a reliable and consistent basis for valuing program land transactions. Acquisitions were examined to determine if the process provides a reasonable assurance of projected future financial performance. Audit work also examined these acquisitions and a sample of program sales to examine the program's process for the identification and preliminary review of land transactions. Assessment work indicated preliminary

review and analysis work is completed by the department's area land offices. As part of audit work, we examined the role of area land offices and the consistency with which they perform program work. Lastly, assessment work indicated program transactions may not be guided by strategic goals for land management activities. We examined how long-term or strategic goals are considered in land banking transactions.

To accomplish our audit objectives, we completed the following methodologies:

- ◆ Reviewed applicable laws, administrative rules, program policies, and reports to the legislature on program activities.
- ◆ Reviewed professional appraisal standards, including the Uniform Standards of Professional Appraisal Practice and the Uniform Appraisal Standards for Federal Land Acquisitions, and the department's process for obtaining and reviewing appraisals.
- ◆ Examined nine acquisition files and a sample of 112 sale files through February 2010 which document operations and activities to assess consistency in identification and review activities, and assess consistency, and compliance with responsibilities outlined in statute, administrative rules, and professional standards regarding program appraisals.
- ◆ Examined financial analyses for all nine program acquisitions to assess consistency and data utilized to perform work.
- ◆ Interviewed department and program staff, both in Helena and at the department's six area land offices.
- ◆ Interviewed land owners who have participated in the program.
- ◆ Interviewed appraisers who have conducted work for the program.
- ◆ Examined similar land management programs for private industry and government in other states.

Potential Areas for Future Audit Work

During the course of audit work, we determined there was an issue related to the program which would merit attention for future audit work.

- ◆ **Trust Land Grazing Leases** Audit work indicated that when a land banking sale on a grazing property is unsuccessful, the land continues to be managed under the previous leasing agreement for generating annual revenue. Individual grazing leases generate minimal revenue on trust lands. Future audit work could examine the process by which grazing leases are established and if these leases are generating the maximum revenue possible for trust beneficiaries.

Report Contents

The remainder of this report includes a background chapter followed by chapters detailing our findings, conclusions, and recommendations in the following areas:

- ◆ Chapter III presents information regarding the appraisal of land for the program.
- ◆ Chapter IV presents information on how the department could improve management controls for the program.

Chapter II – Program Background

Introduction

This chapter provides background information on the history of trust lands, the management of trust lands in Montana, the Land Banking Program, and recent program activity.

A History of Trust Lands

As part of the various federal enabling acts which authorized the admission of new states into the United States, newly formed states were granted lands from the federal government to support a public education system, commonly known as trust lands. For example, by the Enabling Act of 1889, the Congress of the United States granted the State of Montana sections sixteen and thirty-six in every township within the state. Since some of these sections had been homesteaded or were within the boundaries of Indian Reservations other lands were selected by the State. While the amount of land granted to each state varied due to when they were admitted to the United States, all states were similarly granted land by the Congress. However, as a result of timing, some state trust lands are scattered small parcels while other states have large consolidated tracts of land.

Over time, many states have chosen to sell these lands and place the proceeds into a permanent “trust fund” to be used for the purpose of generating revenue for trust beneficiaries. Trust beneficiaries are public education institutions such as K-12 schools and universities, which receive trust revenue to support educational programming. A number of other states, mainly in the western part of the United States, have chosen to hold onto these lands and manage the property to generate revenue for trust beneficiaries. When land is sold, these proceeds are also placed in a permanent trust fund. Beneficiaries earn revenue from both the permanent trust and the property revenue.

Trust Lands in Montana

Through the years, the total trust acreage in Montana has fluctuated due to the sale and acquisition of trust lands. The current total acreage, including both mineral and surface acreage, exceeds 11 million acres. The distribution of trust revenue from this acreage to beneficiaries varies based on the purposes outlined in the granting acts. Generally, the proceeds—or a part thereof—from the sale of trust lands constitute permanent funds for the various educational institutions for which the lands were granted. Rental income, lease income, interest earned on the permanent funds, other interest earnings, and all other income are distributed to beneficiaries for the maintenance and support

of the educational institutions, or beneficiaries. However, distribution of revenue varies depending on the requirements of the granting act. In Montana, trust beneficiaries include educational institutions such as public universities and K-12 schools.

Who Manages Trust Lands

In Montana, the Department of Natural Resources and Conservation Trust Land Management Division manages trust lands on behalf of trust beneficiaries, under the direction of the State Board of Land Commissioners. The land board consists of Montana's five top elected officials, including the Governor, the Attorney General, the Superintendent of Public Instruction, the State Auditor, and the Secretary of State. The land board is charged with overseeing the management of trust land in the state. It is their responsibility to decide how to best generate revenue for beneficiaries. The mission of the division is to manage the state's trust land resources to produce revenue for the trust beneficiaries while considering environmental factors and protecting the future income-generating capacity of the land. The division manages state trust surface and mineral resources for the benefit of public education and other endowed institutions. Programs include timber harvesting and forest improvement; oil, gas and other minerals leasing; commercial real estate development; easements and cabin-site leases; agricultural and grazing leases; and recreational use.

The Land Banking Program

Established by the Legislature in 2003, the program provides the department with the ability to utilize proceeds from the sale of generally isolated state trust lands to purchase replacement trust lands or property improvements, which are likely to generate as much or more revenue than the land sold. The program made its first sale in 2006. Sections 77-2-361 through 77-2-367, MCA, outline the program's roles and responsibilities. Based on this statutory guidance, the program has established the following goals:

- ◆ Diversify land holdings in order to minimize the risk of financial loss
- ◆ Maximize the sustained rate of return to the trusts
- ◆ Improve public access to state trust lands
- ◆ Consolidate land ownership to enhance land management activities

Per administrative rules, only a current lessee who leases a particular piece of trust property, the department, or the land board may nominate—or identify—a trust parcel for potential sale. Anyone may nominate a parcel for purchase by the program. After nomination, the department examines the property to determine its suitability for the program, based on criteria in state law and administrative rules. Lessees are responsible for program costs including assessing suitability and contracted appraisals,

if applicable. If a parcel meets the criteria of the program for sales, the land board sets a minimum bid and the parcel is available for sale at public auction. Likewise, if a parcel meets the criteria for program acquisition, the land board directs the department to purchase the parcel. Determining the suitability of a parcel will be discussed further in Chapter IV of this report.

Per §77-2-362(2)(d), MCA, when the program sells a parcel of trust land, the proceeds are deposited into a temporary trust fund. These proceeds are available to purchase replacement trust lands. Interest on these funds is distributable to beneficiaries. Proceeds may not be held in these temporary funds for a period to exceed ten years after the date of each sale. After ten years, the funds must be deposited in the permanent trust fund of the respective trust. Since 2003, sale transactions total approximately \$21 million; acquisition transactions exceed \$15 million. The program has sold nearly 42,968 acres of trust land and purchased about 31,588 acres of replacement land. While the program is centrally located and administered in Helena, program review activities

primarily take place in one of the department's six area land offices, which regionally manage state trust lands. Table 1 represents acreage sold and acquired by the program by land classification through February 2010. Since the close of audit work, the program has acquired an additional 14,581 acres of timber land in July 2010.

Table 1
Land Sold and Acquired by Land Classification Through February 2010

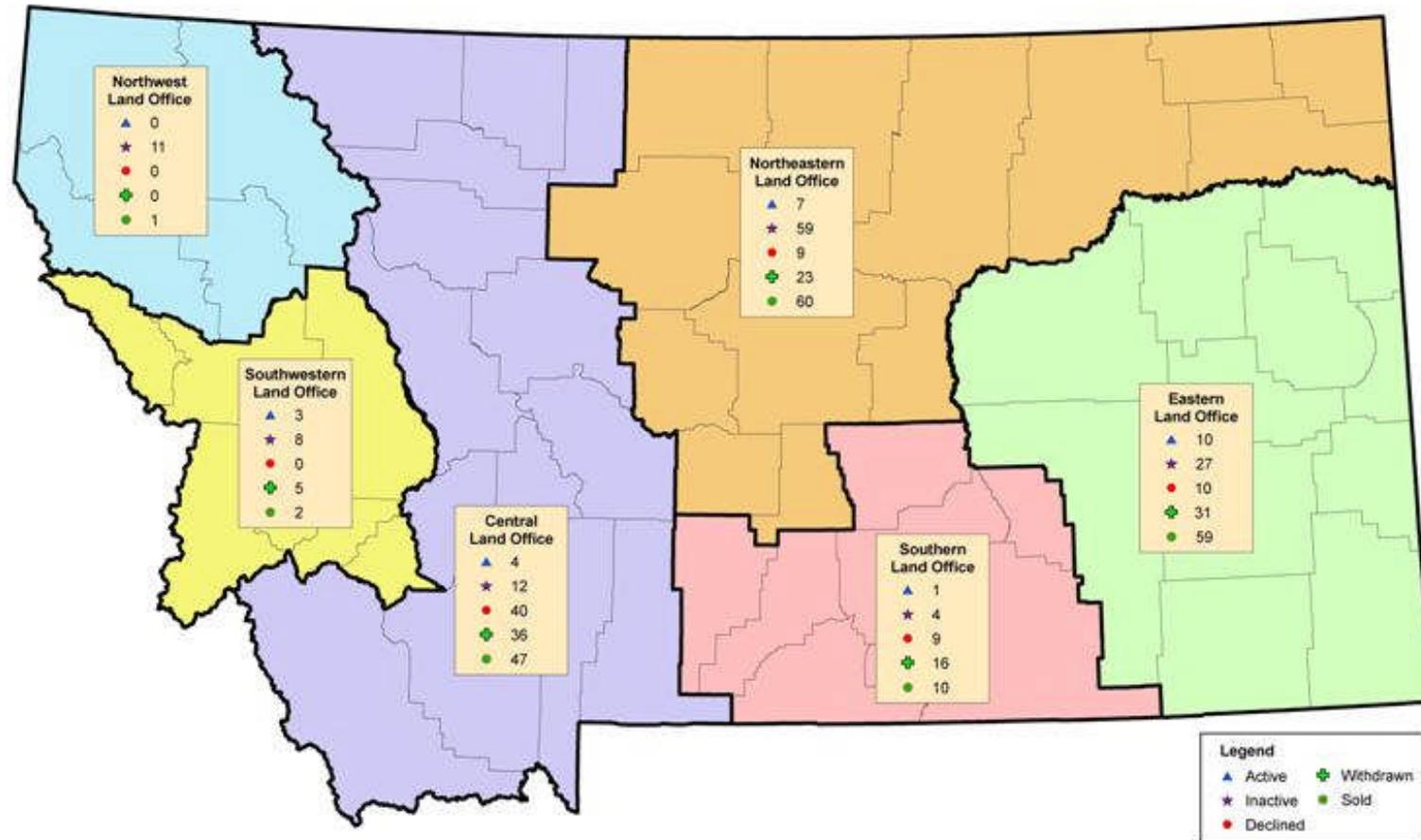
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Other	2	417.2
Totals	42,967.9	31,587.7

Source: Compiled by the Legislative Audit Division from department program records.

Land Banking Program Transactions

Since 2006, the program has acquired ten properties. There have been 504 parcels nominated for sale by the program. Parcels nominated for sale fall into five categories, namely sold, withdrawn, declined, active, and inactive. Of those 504 parcels nominated for sale, 179 parcels have been sold across the state. Other parcels nominated for sale are either under active consideration of the department or have been removed from consideration by the department or the lessee who nominated the parcel for sale. Inactive sale nominations represent nominations not fitting any of the other categories and not actively being considered by the department. A geographic map of all 179 program sales and ten acquisitions is located in Appendix A of this report. The following map illustrates total sale nominations in all categories for the program by area land office.

Figure 1
Land Banking Nominations by Area Land Office Through February 2010



Source: Compiled by the Legislative Audit Division from department records.

Chapter III – Program Appraisals

Introduction

In any land transaction, an appraisal forms the basis for the valuation of a piece of property which is to be bought or sold. An appraisal is meant to determine the current fair-market value of a piece of property, including considering the highest and best reasonably available use of a piece of property, as outlined in §70-30-313, MCA. The Land Banking Program is statutorily charged to sell isolated land and use the proceeds to purchase other lands or improvements which are likely to provide greater returns for land trust beneficiaries. As part of this process, the program appraises land for sale and acquisition. To date, the department has sold approximately 80 percent of parcels which have been appraised. As part of our activities, we evaluated the program's process for valuing land sold and acquired by the program. This chapter presents our findings and conclusions relative to the program's appraisal activities, and two recommendations to improve the program's appraisal process.

Program Appraisal Requirements

As part of the program, the department is required by statute to determine the estimated fair market value for sales and acquisitions:

- ◆ Per § 77-2-363(1)(b) and 77-2-364(2), MCA, the estimated fair market value is to be determined by Montana-licensed and Montana-certified appraiser.
- ◆ Section 77-2-364(2), MCA, includes full market value to be realized for each trust beneficiary.
- ◆ Section 77-2-364(4), MCA, directs the department to use the Uniform Appraisal Standards for Federal Land Acquisitions (UASFLA) as guidance for acquisition appraisals.

The administrative rules for the program provide additional direction for the program's appraisal activities. For sales, the department shall contract with a Montana-licensed certified general appraiser, with the department reviewing or contracting for the review of the contracted appraiser. The rules also outline the requirements of the appraisals of sales. The appraisal must:

- ◆ Include state-owned improvements in the valuation.
- ◆ Exclude lessee-owned improvements.
- ◆ Use comparable sales for like properties.
- ◆ Include details of the value of the parcel with legal access and a discount in value due to a lack of access.
- ◆ Be reviewed and or updated one year from the date of the appraisal.

In addition, administrative rules allow a program participant to commission a second appraisal for any reason at their own expense, which must include the same elements of the first appraisal and be submitted to the department for review.

Similarly, for acquisitions, the department shall also contract with a Montana-licensed certified general appraiser to value a parcel under consideration, with the department reviewing or contracting for the review of the contracted appraiser. The rules indicate the appraisal must follow the department's current scope of work and any supplemental appraisal instructions for the parcel; the appraisal must be reviewed or updated within one year of the date of the appraisal by the department. After an appraisal of a potential sale or acquisition, the department presents the results to the State Board of Land Commissioners (the land board) for their consideration. In the case of sales, the land board sets the minimum bid.

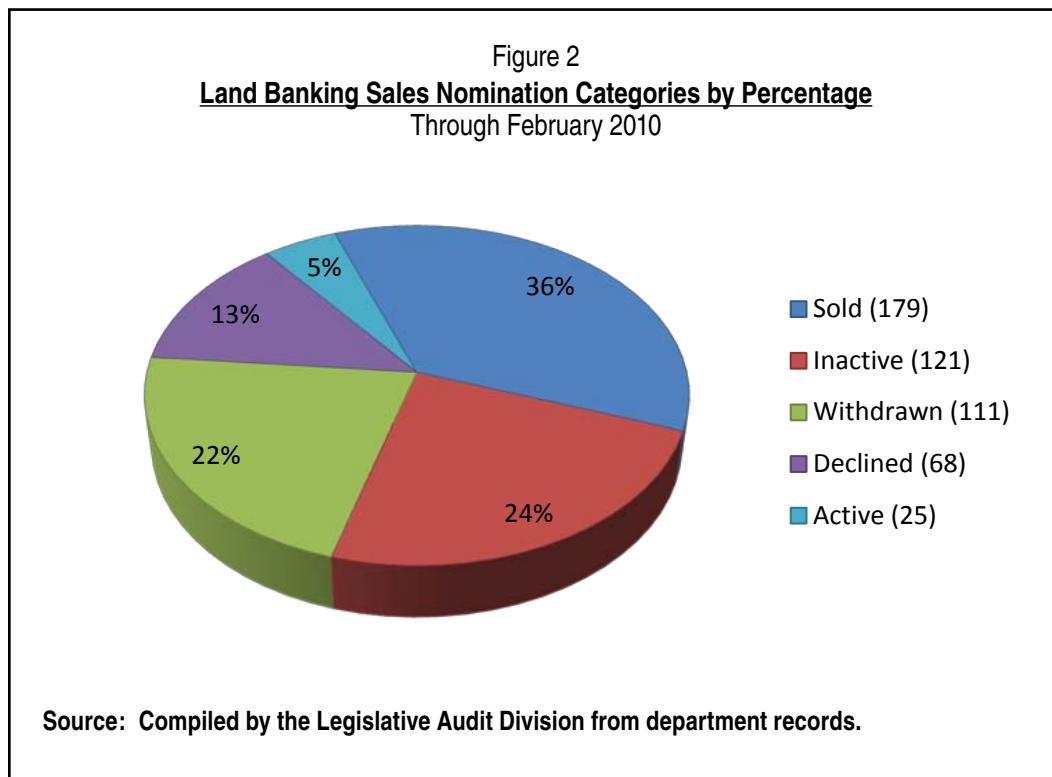
Professional Appraisal Standards

The Uniform Standards of Professional Appraisal Practice (USPAP) represent the generally accepted and recognized standards of appraisal practice. Since the late 1980's, USPAP is recognized throughout the United States as the generally accepted standards of professional appraisal practice. USPAP contains standards for all types of appraisal services, including real estate, personal property, business, and mass appraisal. USPAP includes standards and rules for appraisal development, consulting, reporting, and review. In Montana, the Board of Real Estate Appraisers is responsible for the licensing and regulation of real estate appraisers in the state. As part of the application process to become a real estate licensee in Montana, the board requires qualifying education in USPAP. Program appraisal activities are guided by USPAP standards.

The federal government adopted UASFLA as uniform appraisal standards and guidelines for appraisal reports. These standards promote uniformity in the appraisal of real property among the various federal agencies acquiring property on behalf of the United States. The appraisal of property by the federal government is determined to a great extent by federal law. Subsequently, the opinions of an appraiser are governed by legal standards. UASFLA and USPAP are essentially identical appraisal standards, with USPAP forming the basis for UASFLA and only deviating from USPAP when a federal law or regulation precludes USPAP.

Program Sale Appraisals Do Not Always Comply With Administrative Rules

As part of audit work, we reviewed appraisals and appraisal reviews for all nine program acquisitions and a sample of parcels which have been nominated for sale to evaluate the process for valuing land purchased and sold by the program. To date, 504 parcels have been nominated for sale. Total program nominations for sales are as follows:



We sampled approximately 20 percent of each nomination category in each of the department's six area land offices for a total of 112 parcels nominated for sale. Of our sample, 38 parcels have been sold. Other parcels in our sample are either under active consideration of the department or have been removed from consideration by the department or the lessee who nominated the parcel for sale. Overall, we found our sample demonstrated that appraisals and reviews comply with statutory requirements.

However, we identified that the program does not fully comply with requirements in administrative rule for program sales. Per ARM 36.25.805(9)(b)(iv), appraisals must include "details of the value of a parcel with legal access and a discount in value due to a lack of access." Legal access refers to a legal right of access by the public, such as by a public road or waterway. A discount refers to a reduction in value due to a lack of legal access. In our audit examination, we noted the use of various tools in program appraisal activities. One appraisal tool defined in USPAP allows an appraiser to assume

facts which are contrary to what exists for the purposes of analysis. Through its scope of work which outlines expectations of appraisers, the department directs appraisers to use this tool to value isolated parcels for sale with no legal right of access by the public as though they have access. Of the 38 parcels in our sample which the program has sold, only 50 percent provided both values. The other 50 percent only provided a value with legal access.

Scope of Work Allows Providing Two Values Optional

While administrative rules require both values, the department's scope of work allows appraisers to opt out of providing both values. Appraisers are directed to value isolated parcels as having legal access and also value these parcels without legal access. The scope of work directs appraisers to identify appropriate comparable properties in the subject's market or similar market to value the property without access. However, the scope of work indicates that if an appraiser is unable to find evidence which can support a value without access then to only provide what they can support and state this fact in the appraisal report.

The Selection of Comparables by Appraisers Not Clearly Defined

The lack of both a value with and without legal access also highlights an inconsistency in the appraisal process for sales. During the course of audit work, we noted inconsistencies in the identification and selection of comparables to support property valuations for sales. A comparable is a similar property in size and type used to determine the price the market will support for property for sale. Currently, the department's scope of work only states that property comparables must be in reasonable proximity (within the same county or a neighboring county) to the subject for sale and should have sales dates within one year of the appraisal and cannot be over three years old. In our review, we examined six appraisals, three of which provided both values and three which did not. In the appraisals which provided both values, appraisers generally expanded their geographic examination of comparables. Comparables used for program sales are generally the sale of private land. In practice, appraisers develop a value with legal access based on these private properties with legal access and develop a discount for a valuation without legal access. This discount is developed by identifying comparables without legal access and applying a discount to the valuation with legal access.

Without Definition Appraisals Are Inconsistent

Administrative rules require comparables for like properties be used. Those appraisers who did not provide a value without legal access indicate there is no market data, or a lack of property comparables without legal access, to support a valuation. Consequently,

they are unable to develop and apply a discount rate to comparables with legal access to support a value without legal access. This inconsistency is based on a number of factors. Some appraisers widen their geographic scope of their search for comparables. Some appraisers use statewide data to support their work, while others do not expand their scope due to a fear of their data losing applicability. In addition, some appraisers use former program sales as property comparables. These former sales generally are isolated parcels without legal access which have been sold with the value of having legal access. Some appraisers think they are appropriate comparables; others think these parcels are not appropriate to use as comparables. Based on our review of the department's scope of work, it was unclear what constitutes a comparable for program sales.

Administrative Rules Require Two Values But Do Not Define

As noted earlier, per ARM 36.25.805(9)(b)(iv), appraisals must include "details of the value of a parcel with legal access and a discount in value due to a lack of access." However, the department's scope of work for program sales appraisals presently directs appraisers to only provide both values if they are able to find comparables to support both values. Beyond the broad definition in the department's scope of work, the use of comparables is not clearly defined. The department is not complying with existing administrative rules via its scope of work. This instance of noncompliance is compounded by the fact that some appraisers provide both values, while others are not. This inconsistency in the identification of comparables highlights the fact that the department does not comply with existing administrative rules and has not clearly developed what constitutes an appropriate comparable for the program in its scope of work.

RECOMMENDATION #1

We recommend the Department of Natural Resources and Conservation revise their scope of work for program appraisals of property sales to:

- A. *Comply with administrative rules.*
- B. *Clearly define what constitutes a comparable for program sales.*

Valuing Isolated Parcels With Legal Access

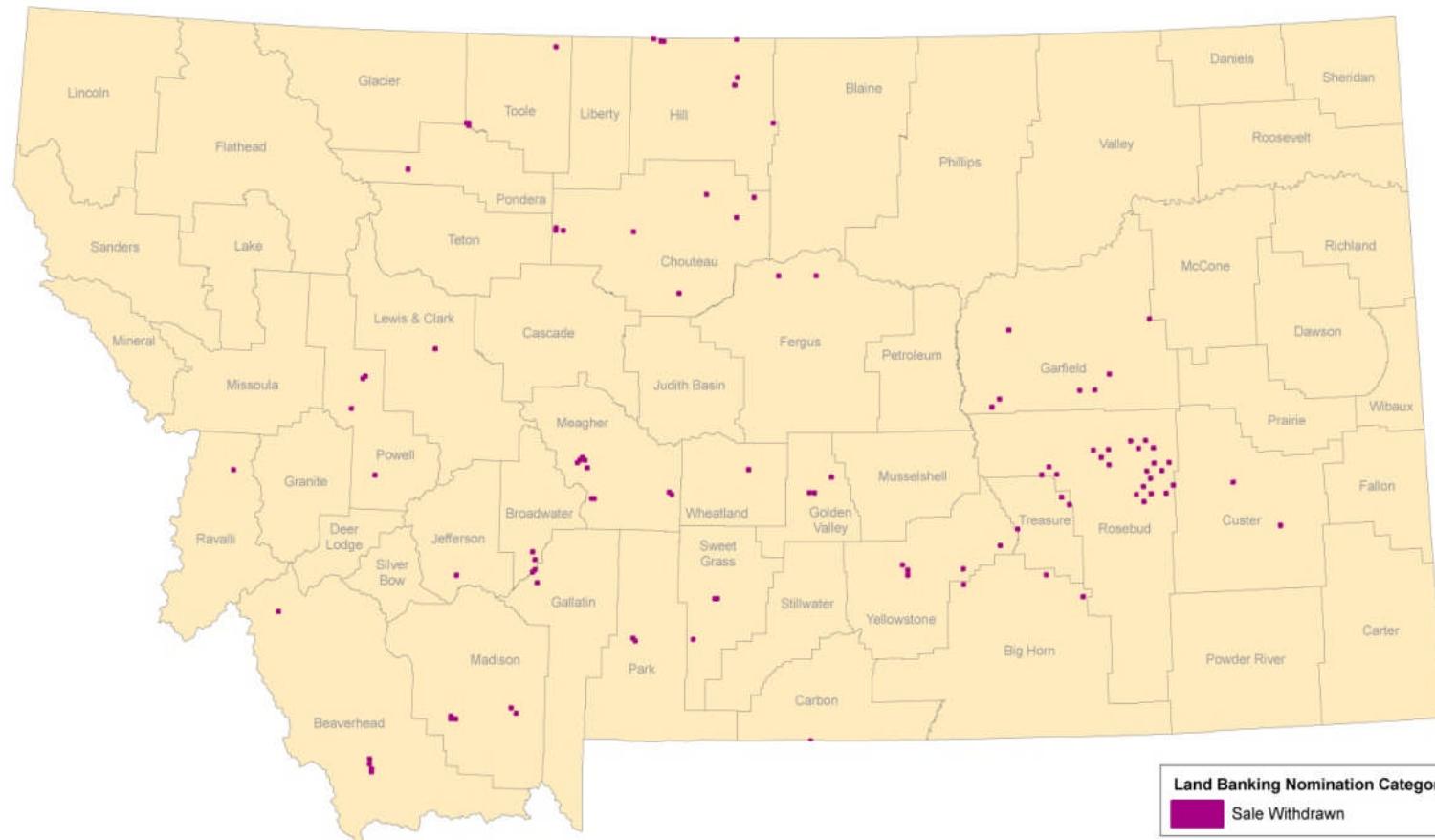
Since the majority of land banking parcels are isolated parcels without legal access, the department has directed appraisers to establish a value with legal access when none

exists. In our audit examination, we noted the use of various tools in program appraisal activities. As noted, one appraisal tool defined in USPAP allows an appraiser to assume facts which are contrary to what exists for the purposes of analysis. Through its scope of work which outlines expectations of appraisers, the department directs appraisers to use this tool to value isolated parcels for sale with no legal right of access by the public as though they have access.

This Practice Results in Program Participants Withdrawing From the Program

As a result of valuing an isolated parcel with legal access when none exists, the value of land banking parcels for sale increases. Consequently, program participants—a current lessee who leases a particular piece of trust property—who have nominated a parcel for sale may withdraw from the program. Since the lessees who nominate these parcels are generally the adjacent land owners who control access to the subject parcel, the department indicates that as soon as the lessee purchases the property they gain access and increase the value of their surrounding land holdings. Our audit work indicated approximately 40 percent of lessees who withdraw from the program cite the appraised value is too high and does not represent the true value of a parcel. While the appraised price is not the only reason why a lessee may withdraw from the program, the practice of valuing isolated parcels with legal access when none exists can inhibit the program and provide a disincentive to lessees to participate. Since 2006, there have been 504 parcels nominated for sale by the program. Of those parcels nominated for sale, 111 parcels (or 22 percent) have been withdrawn from the program by lessees. The following map illustrates total withdrawals for the program statewide.

Figure 3
Land Banking Nominations Withdrawn by Lessees Through February 2010



Source: Compiled by the Legislative Audit Division from department records.

What is in the Best Interests of Trust Beneficiaries?

When a lessee withdraws from the program, the sale of a parcel is canceled and the land reverts back to producing limited lease income for trust beneficiaries. Historically, when provided both appraised values, the land board has always chosen the higher value to set the minimum bid for a sale parcel. In the case of grazing leases, the amount of annual revenue generated for beneficiaries is minimal and calls into question what is in the best interests of beneficiaries when setting the minimum bid. In our review, we examined six appraisals, three which provided both values and three which did not. In the appraisals which provided both values, the value with access when none existed increased the price between approximately 20 to 70 percent. For example, one 640-acre isolated grazing parcel withdrawn from the program was appraised with both a value without and with legal access. The appraised price ranged between \$67,600 and \$112,600 (nearly a 70 percent increase in price). Since this parcel currently generates an average income of \$651.88 annually it would take the state approximately 110 years to generate and match the market value of the parcel without legal access. Generating the increased market value of the parcel with legal access would take approximately 172 years. Had the lower appraised value been considered to set the minimum bid, the lessee may have purchased the parcel. Without sale proceeds, the program is unable to purchase replacement properties which may provide greater financial returns for trust beneficiaries.

The Program Appears Focused on Short-Term Impacts

Presently, the program appears focused on capitalizing on the immediate value of these parcels, rather than considering what may be in the long-term interest of beneficiaries. However, it is important to note some of these parcels do have actual legal access. For example, one 40-acre grazing parcel withdrawn from the program by the lessee due to an appraised price of \$72,000 actually had legal access. This parcel generates an average income of \$54.36 on an annual basis. While this parcel generates limited income for beneficiaries, the appraised value reflects actual access and the possibility of the parcel being developed in the future as a rural residential site. In these circumstances, the program should maintain their position to generate the maximum amount of revenue for trust beneficiaries and sell the property for the highest price possible when a lessee withdraws due to the appraised price. However, when it appears unlikely there will be an opportunity to sell an isolated parcel due to valuing it with legal access, the program should fully consider the long-term interests of trust beneficiaries. Currently, the program does not assess on behalf of the land board these types of considerations and balance the short-term and long-term returns to beneficiaries of attempting to sell a parcel for the highest price possible. As noted, based on statutory guidance, the program has established a goal to maximize the sustained rate of return to the trusts. The practice of selling a parcel for the highest price possible does not appear to

achieve that goal when considering the limited lease income isolated parcels generate for beneficiaries.

Other States Define Or Will Negotiate When Valuing Isolated Parcels With Access

The sale and appraisal of trust land in other states is a common practice. However, other states which appraisal trust land for sale generally do not require two values. Land is either appraised as is or an appraisal tool is used to establish a value with legal access when none exists. Like Montana, other states use this tool to maximize revenue for trust beneficiaries. In contrast to Montana, other states have either defined the use of the practice or negotiate the value. For example, Idaho justifies the practice in its asset disposal strategy guidance. And in Wyoming, the program may discount the rate of an isolated parcel valued with legal access by the cost of building a road to access the property as a way to sell the land.

RECOMMENDATION #2

We recommend the Department of Natural Resources and Conservation document the consideration of the short and long-term financial impacts to beneficiaries when trying to sell an isolated parcel with legal access.

Chapter IV – Management Controls

Introduction

As part of audit work, we evaluated the Land Banking Program's process for determining if a land parcel is a suitable candidate for the program, including the process for projecting rates of financial return on potential acquisitions. This chapter presents our findings and conclusions relative to these activities and presents three recommendations to improve management controls for the program.

Management Controls for the Program Could be Improved

Management controls are developed and implemented by management to ensure programs achieve intended results, programs and resources are utilized effectively and managed appropriately, and laws and regulations are followed. While the program is centrally located in Helena, due to the organizational structure of the department, the majority of program review activities take place in one of the department's six area land offices, which regionally manage state trust lands. Our audit work noted a lack of active management for the program by the department and a general deference within the department to allow area land staff to individually guide program activities, rather than adhering to a centralized set of practices. Program staff indicate they do not oversee area land staff and do not have the authority to direct their activities. According to department management, they believe that local perspective of area land staff strengthen program activities. However, the program provides a statewide perspective and context for the management of trust land resources which may not be the focus of area land staff. As part of audit work, we examined a program handbook which outlines the rationale and process concerning the sale of state trust lands to the public and the acquisition of land by the state. The handbook also outlines roles and responsibilities for program and area land staff. However, the handbook could further define how the local activities of area land staff fit into the larger context of management of state trust lands. We determined management controls could be improved related to:

- ◆ Documenting program activities.
- ◆ Identifying suitable parcels for sale and acquisition.

In addition, audit work indicated that the evaluation of acquisition financial performance is presently not a formal program activity. The following sections of this chapter will examine each of these areas relative to the program. While these areas will be discussed individually, they are closely related to one another and represent separate but interconnected components of an overall system of management controls for the program. The following sections describe steps that will help the department more actively manage the program.

Determining if a Parcel is a Suitable Candidate for the Program

State law provides general direction for the program, with administrative rules outlining the process and factors to consider when evaluating the suitability of potential parcels for the program. Per §77-2-363(1)(a), MCA, the department may not sell more than 250,000 acres of trust land, with 75 percent of the land sold being isolated parcels not possessing a legal right of access for the public. For program acquisitions, per §77-2-364(4), MCA, the department must develop revenue projection procedures to ensure the land proposed for purchase are likely to produce more net revenue than was produced from the land sold. It is important to note that approximately 95 percent of parcels sold have been isolated. All parcels acquired by the program are 100 percent accessible to the public.

Program Sales

Administrative rules for the program outline a preliminary review, nomination, and environmental review process for program sales. Only the department, the land board, or current lessee may nominate a parcel for sale. For sales, administrative rules contain a list of factors which the department may consider in a preliminary review. Based on this preliminary review, the department is required to make a determination whether the parcel qualifies for nomination. After a parcel has been nominated, the department performs an environmental review describing any potential impacts and mitigations the sale would have on any natural resources. After the preliminary review, nomination, and environmental review, the department makes a determination on a parcel's suitability for sale. At this point, the information goes before the land board for preliminary approval to sell the parcel.

Program Acquisitions

Likewise, administrative rules outline a nomination and preliminary review process for program acquisitions. Any person may nominate a parcel for acquisition. After the nomination, the department is required to conduct a preliminary review to determine a parcel's suitability for acquisition. After the nomination and preliminary review, the department makes a determination whether or not the property is suitable and presents it to the land board for preliminary approval. If the parcel receives preliminary approval from the land board, the department conducts a financial analysis to project the estimated financial return on a potential acquisition.

Key Program Decisions Are Not Consistently Documented

As part of audit work, we reviewed program land transaction files in Helena for nine program acquisitions and a sample of trust parcels which have been nominated for sale to evaluate the program's process for determining parcel suitability. As noted earlier,

a total of 504 parcels have been nominated for sale since 2003. Parcels nominated for sale fall into five categories, namely sold, withdrawn, declined, active, and inactive. Inactive sale nominations represent nominations which do not fit any of the other categories and are not actively being considered by the department. Refer to figure 2 in Chapter III for program nominations all categories.

These 504 nominations formed the basis for our sampling population. We sampled approximately 20 percent of each nomination category in each of the department's six area land offices for a total of 112 parcels nominated for sale. Table 2 represents our sample population for sales by nomination category.

We also reviewed the same transaction files located in five of the department's six area land offices, since area land management staff identify and prepare preliminary analysis work and provide to program staff in Helena. While the program is centrally

located and administered in Helena, program review activities primarily take place in one of the department's six area land offices, which regionally manage state trust lands. Program files in area land offices can be best characterized as working files, with permanent program documentation located in Helena. However, there was not always a clear connection between working files in area land offices and permanent files in Helena. For example, some working files contained more supporting documentation than permanent files. In our review, it was unclear

what documentation should be housed in which location to document key program decisions or which staff are responsible. The following represents areas where we noted inconsistencies in maintaining documentation to support key program decisions in the permanent program files in Helena.

Permanent Sale Files in Helena

- ◆ Nine of 112 sale files (8 percent) were missing.
- ◆ Thirty-eight of 112 sale files (34 percent) did not contain any documentation regarding nomination or preliminary review information.
- ◆ Twenty of 36 withdrawn and declined sale files (56 percent) did not contain any documentation regarding why the nomination was withdrawn or declined.

- ♦ Twenty-seven of 27 inactive sale files (100 percent) did not contain any documentation as to why the nominations were not being actively considered.

Permanent Acquisition Files in Helena

- ♦ Three of nine acquisition files (33 percent) did not contain any documentation regarding nomination information.
- ♦ Two of nine acquisition files (22 percent) did not contain any documentation regarding preliminary review information.

Overall, a lack of a defined process and location for documenting key program decisions limited our ability to determine fully if the program is working as the legislature intended. In our examination, we found these problems because the department has not determined where and when documentation should be retained to support program activities.

RECOMMENDATION #3

We recommend the Department of Natural Resources and Conservation determine when and where documentation should be retained to support program decisions.

Inconsistencies in Process to Identify Suitable Parcels

In addition to program documentation, audit work noted additional inconsistencies in the process by which the department identifies potential parcels for program sales and acquisitions. These inconsistencies include the use of a statewide process for identifying land for disposition and the level to which area land staff are committed to the activities of the program. For example, while program staff have taken steps to ensure potential parcels for sales are identified in a consistent manner, not all area land staff follow this process. Program staff are actively developing an initial filter or threshold for identifying potential program sales based on grazing productivity and other factors; however, not all area land staff use this filter. In part, the filter targets parcels which have a grazing productivity rate which falls below the statewide average for a grazing lease on trust lands as initial criteria for program consideration for sales. Program staff are developing this filter on a county by county basis. Program staff indicate this filter is being developed as a starting point from a review perspective for area land staff. However, some area land staff use the filter, while others think it more effective for them, in their role as the local area land managers, to identify which parcels are suitable candidates for sale. In addition, area land staff in timber-rich regions of the state have independently developed a process to identify timber land for disposition.

Not All Parcels Which Could Be Suitable Candidates Are Considered

As noted, the level of commitment on the part of area land staff in the program was identified as an inconsistency in the process to identify parcels. Due to either interest or knowledge of the program, some area land staff are more actively engaged in the program. For example, area land staff in a number of offices indicated that while there are parcels which would be perfectly suitable candidates for the program, they have chosen not to actively pursue due to potential controversy, such as access or recreation issues. Area land staff indicate while many parcels are isolated and hard to manage, in some circumstances these parcels are adjacent to other public land or provide areas for recreation. Consequently, the parcels generate controversy with members of the public when nominated. As such, area land staff actively choose to not nominate these types of parcels, despite the fact they may be suitable candidates for the program. Area land staff also indicate they have received informal direction from the department not to nominate these types of parcels. In addition, due to recent staff turnover, some area land staff are more knowledgeable about the program than others. As a result, some area land staff are actively working to identify parcels for the program, while others have a limited awareness of the program and do not participate. Regarding program acquisitions, area land staff individually identify potential candidates based on interest, opportunity, or work experience. As noted, the program provides a statewide perspective and context for the management of trust land resources which may not be the focus of area land staff. It should be noted that while there are inconsistencies in the process by which potential parcels are identified for the program, all parcels are judged by the same criteria for suitability. The program has developed a preliminary review checklist which outlines criteria area land staff use to judge the suitability of a potential parcels after it has been identified. However, there are no guidelines which direct area land staff in identifying program parcels. While it is important for the program to develop guidelines for area land staff to identify parcels, any guidelines should take into account the local conditions of each area land office while retaining a statewide perspective for the management of trust lands.

As a result of the inconsistencies in the way area land staff identify potential sale parcels for the program, not all parcels which could be suitable candidates are actively being considered. As noted, area land staff are either not consistently using the same process to identify potential parcels or are choosing not to pursue potential candidates for the program, due to controversy, interest, or a lack of knowledge. Similarly for program acquisitions, some area land staff are more actively engaged than others. While program acquisitions fit the existing criteria of the program, they are not identified as the result of strategic or long-term goals. Rather they appear to be opportunities, whether driven by area land staff at the local level or by current political priorities.

RECOMMENDATION #4

We recommend the Department of Natural Resources and Conservation:

- A. Establish adaptable statewide guidelines for identifying parcels for sales and acquisitions.
- B. Take steps to ensure identified parcels fall within these guidelines.

Projecting Rates of Financial Return on Potential Acquisitions

Pursuant to its fiduciary duties outlined in state law, the department is required to develop revenue projection procedures which ensure that land which is purchased through the program is likely to produce more net revenue than land sold for trust beneficiaries. According to the program, while land sold generated \$60,644 annually, the land acquired is estimated to generate \$303,746 annually, providing greater revenue for trust beneficiaries. Audit work indicated that the program has developed revenue projection estimates for all program acquisitions to assess the financial risks and benefits of a potential purchase. While the department has established revenue projection procedures, there is no requirement to evaluate program acquisitions on a periodic basis to determine whether they are performing as expected.

The Department Does Not Formally Evaluate Ongoing Performance of Acquisitions

While the program is able to estimate projected rates of financial return, it does not have a formal process to evaluate ongoing performance and determine future strategies for land disposition and acquisition. Without a formal process in place to evaluate program acquisitions on a periodic basis, the department is unable to determine whether they are performing as expected. Since trust land revenue provides funds for the support and maintenance of the various educational institutions for which the land was granted, without a process to evaluate acquisitions, the department cannot clearly establish that the acquisitions are in the best interests of trust beneficiaries. Since program acquisitions are projected to provide long-term revenue for trust beneficiaries, it is important for the department to know if they are performing as expected.

According to program staff, they have performed some informal verification of estimated returns for past purchases; per staff, purchases they have checked are generally performing better than expected. While staff generally think it would be

a good standard practice to evaluate returns on a periodic basis, they indicate that it would have to be limited to immediate annual income. They express concerns regarding evaluating performance of lands which are projected to produce revenue over the next 60 years and consequently have not formalized the process. Staff indicate that due to the long-term nature of some of the projections there has not been a push or need on the part of the department to establish a formal process to evaluate acquisition performance.

The Department Has Recently Established a Statewide Asset Management Plan

In July of 2010, the department presented an asset management plan to the land board to provide strategic direction for the management of the state's trust surface ownership. According to the plan, department mission and asset management principles guide the department to actively seek out opportunities to enhance asset revenue, to diversify trust assets, and to improve core asset performance. The asset management plan was the result of direction by the 2009 Legislature, which provided bonding authority for the department to purchase 30,000 acres for trust beneficiaries near Potomac, Montana. HB674 stated the acquisition be: "managed pursuant in accordance with an asset management plan to minimize the risk of loss and maximize the sustained rate of return." While the department has recently established an asset management plan for trust lands, the plan is a conceptual document and does not specifically define how the activities of the program fit into the broader management of state trust land. The plan does model shifts in the portfolio by land class and expected returns. However, the plan does not specifically set performance targets or establish the periodic evaluation of asset performance.

Other States Have Established Comprehensive Asset Management Plans for Trust Land

States which sell and acquire trust lands generally do so with the intention to increase revenue for trust beneficiaries and diversify land holding portfolios. While all states have established some level of criteria to guide their activities, some states have established formal land asset management plans which define acquisition and disposal strategies, including benchmarks for performance and processes to evaluate performance. For example, Idaho's State Trust Lands Asset Management Plan defines the state's criteria for the acquisition and disposal of trust land. This plan includes targeted rates of return for each type of land classification, which provide one basis for acquisition and disposal activities. Other criteria which the plan considers for acquisition and disposal include: legally accessible, highest and best use, market demographics, location, and investment risk. The plan further defines criteria by land classification. For example, different criteria apply to different land classifications, such as grazing, timber, agricultural, or

commercial property. Under-performing assets are examined on an annual basis and remedies developed to address. For example, if an asset is not performing as expected, it may be disposed of or the program may stop purchasing that classification of land. Likewise, Oregon's Asset Management Plan defines key strategies for the acquisition and disposal of trust lands, including developing performance targets for specific land types. For example, their plan takes a regional approach and targets lands in specific regions of the state for acquisitions due to expect growth, such as urban areas in the path of progress in the central part of the state. In this manner, the plan is meant to be a tool to direct staff time and resources and develop work plan priorities. The plan also identifies specific lands for retention. Disposition criteria includes lands which are currently not leased or do not meet performance targets. The plan requires that performance targets be evaluated on a periodic basis.

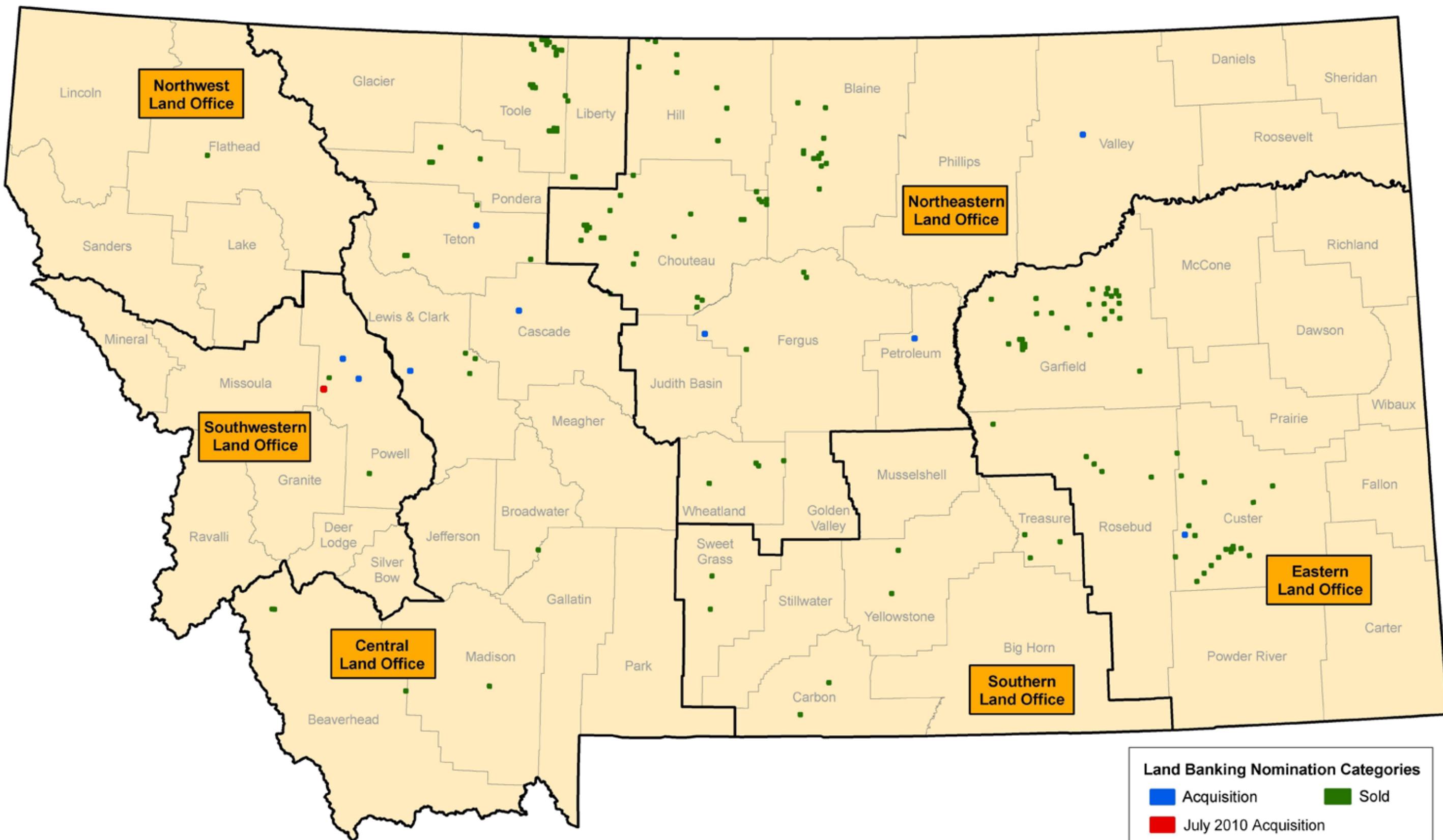
The Department Evaluates Other Programming

The department has developed performance strategies for other programs. The department's Real Estate Management Plan, which outlines criteria for the development of commercial and residential property on trust lands based on location and development density, includes a provision to monitor trust land sales for a period of five years after the date of sale. Land sales are monitored if properties sold receive subdivision approval through a local regulatory process. Monitoring serves as the basis to identify processes to modify the plan as appropriate and necessary to make adjustments. A similar approach is needed for the land banking program.

RECOMMENDATION #5

We recommend the Department of Natural Resources and Conservation establish a formal process to periodically evaluate the performance of land banking acquisitions.

Land Banking Sales and Acquisition Through February 2010



Source: Compiled by the Legislative Audit Division from department records

DEPARTMENT OF
NATURAL RESOURCES
AND CONSERVATION

DEPARTMENT RESPONSE

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION

B-1



BRIAN SCHWEITZER, GOVERNOR

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September 3, 2010

Angie Grove, Deputy Legislative Auditor
Performance Audits
Room 160, State Capitol
P.O. Box 201705
Helena, Montana 59620-1705

Dear Mrs. Grove:

Thank you for the opportunity to review and comment on the 2010 performance audit of the Land Banking Program. The land banking program is an important trust land management tool for the state, and the audit report provides direction for the program both in the present and future. The report correctly addresses the significant issues we face with the process: **valuing lands sold and acquired through the program, determining suitable candidate land parcels for the program, and projecting rates of financial return on potential acquisitions.**

We have thoroughly reviewed the September 2010 performance audit of the Land Banking Program. The Department agrees with the five audit recommendations and will take the necessary actions regarding the recommendations directed at the Real Estate Management Bureau. We appreciate your in depth analysis of this complex program and look forward to implementing improvements to the program.

Sincerely,

A handwritten signature in black ink, appearing to read "Mary Sexton".

Mary Sexton, Director
Montana Department of Natural Resources

LAND BANKING PROGRAM AUDIT – DNRC RESPONSES

SEPTEMBER 2010

Recommendation #1. A

We recommend the Department of Natural Resources and Conservation revise their scope of work for program appraisals of property sales to:

- A. Comply with administrative rules.

Response: Do Concur

DNRC will modify ARM 36.25.805 (9)(b)(iv) to reflect that the appraisal scope of work is only to provide both values with access, and a discounted value for the lack of access, if appraisers are able to find comparable sales to support both values.

Recommendation #1.B

Clearly define what constitutes an appropriate comparable.

Response: Partially concur

The current scope of work for appraisals indicates that appraisers must be competent and that the opinion of value rendered by the appraiser must be credible and conform to the latest edition of Uniform Standards of Professional Appraisal Practice (USPAP). As discussed on page 12 of the audit report, additional specific instructions are also contained in the appraisal scope of work. Per MCA 77-2-363(1)(b), and ARM 36.25.805(9), DNRC currently contracts with Montana – licensed, certified general appraisers; therefore, the scope of work for an appraisal need not detail all aspects of each approach to value. Those appraisal guidelines are detailed in USPAP, as discussed on page 10 of the audit report.

The DNRC staff appraiser reviews all appraisals for completeness, accuracy, and compliance with the USPAP standards prior to accepting the appraisal report. Each appraisal must be credible, in compliance with USPAP and not misleading or it will not be accepted. DNRC will continue to review all appraisals and will look for inconsistencies, and additionally continue to review the appropriateness of the appraisal scope of work.

Recommendation #2

We recommend the Department of Natural Resources and Conservation document the consideration of the short and long-term financial returns to beneficiaries when trying to sell an isolated parcel with legal access.

Response: Do concur

Short and long term financial analysis is conducted in accordance with ARM 35.25.815 and MCA 77-2-364. Additionally, the environmental assessment conducted on each sale parcel, analyses the impacts of sale and no sale. DNRC will include this information in the Land Board agenda item.

Historically when the Land Board has been presented with land values reflecting access and no access, they have chosen to set minimum bids at the value with access. Of the sales analyzed in the audit, if the Land Board had chosen to set the minimum bid at the value without access, it would have resulted in a reduction of land sale revenue to the state an amount equal to \$6,349,643.

Recommendation #3

We recommend the Department of Natural Resources and Conservation determine when and where documentation should be retained to support program decisions.

Response: Do concur

When the land banking program was initiated, sale numbers were issued for parcels that were nominated by the department. In some cases, the parcel did not progress to preliminary land board approval, and the paperwork was not provided for the official file. All sold files are in place. The nine files that were missing were files checked out by staff for processing. Some documentation that was not contained in the hard copy files is stored electronically in TLMS or in working file folders on DNRCs directory.

The Land Section will implement procedures to ensure proper documentation is created and retained for supporting program decisions. Procedures will identify necessary documentation and staff responsible for creating and maintaining the documentation either in hard copy or electronic formats.

Recommendation #4 A.

We recommend the Department of Natural Resources and Conservation establish adaptable statewide guidelines for identifying parcels for sales and acquisitions.

Response: Do concur

In addition to the land banking handbook for the staff that provides direction on how to implement the statutes and administrative rules, the department has developed an asset management plan per MCA 77-1-219 (4)(b). This asset management plan provides guidance for sales and acquisitions in addition to the criteria provided for in statute and rules for land managers to consider when identifying parcels.

Forms will be updated to include elements of the Asset Management Plan for evaluation purposes to determine if a parcel is suitable for sale or acquisition. The staff handbook will be modified accordingly and from time to time to address changing conditions in statutes, rules, and planning documents.

Recommendation #4B.

We recommend the Department of Natural Resources and Conservation take steps to ensure identified parcels fall within these guidelines.

Response: Do concur

Annually the Division along with Bureau and Land Office staff will review potential acquisitions and dispositions to ensure they meet the goals of the Asset Management Plan for selling and acquiring trust lands. Secondly, the Division, Bureau and Land Offices will develop goals and objectives related to selling and acquiring lands that meet criteria established in code and rule, consistent with the Asset

Management Plan. Thirdly, the Division will report program compliance and accomplishments to the Environmental Quality Council, biennially as required by MCA 77-2-366.

Recommendation #5

We recommend the Department of Natural Resources and Conservation establishes a formal process to periodically evaluate the performance of land banking acquisitions.

Response: Do concur

In accordance with MCA 77-2-366, the department develops and updates a land banking report in July prior to a legislative session. Additionally per MCA 77-1-223, the department produces a Return on Asset Report, which details performance of all state trust lands. The land banking report includes the forecasted or actual revenues and returns on the properties sold and acquired. The department will formally include in the land banking report actual revenues (when available) and returns from land acquisitions for a period up to ten (10) years. After that time, returns and revenues will be reported in association with all state trust lands in the Return on Asset Report.